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THE DIRECTOR OF CENTRAL INTELLIGENCE

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National Intelligence Council

MEMORANDUM FOR: Director of Central Intelligence
Deputy Director of Central Intelligence

THROUGH: Chairman, National Intelligence Council

FROM: Maurice C. Ernst, NIO/Economics

SUBJECT: Perspectives for 1983: The Free World Economy

Attached are my thoughts on the trends and contingencies in the global economy in 1983. Last year I accepted the conventional view, and was dead wrong. This time the uncertainties seem even greater and the world economy more vulnerable to shocks. As a bottom line, I would give high odds on a continued economic slide in the next several months, medium odds on the start of a recovery later in the year, and low, but not insignificant odds on a severe drop at some time in 1983.

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Maurce C. Ernst

Attachment,
As stated

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Perspectives for 1983: The Free World Economy

Conventional wisdom sees the global economy beginning to recover from the current recession within six months or so, the same as last year's estimate, but with a year's delay. Should large additional delays occur, the risks of severe protectionist measures and of a backlash from LDC debtors will increase substantially.

The world economy is still sliding downward. Industrial production continues to fall in the US and has now declined for three successive quarters in Western Europe. World trade began declining in the latter part of 1981; the decline accelerated to a rate of 11 percent in the third quarter of this year, and fourth quarter results are likely to be even worse, reflecting the deepening recession in several European countries and in major LDCs such as Mexico and Brazil.

World economic recovery will probably have to begin in the United States, where real personal incomes are rising slowly and housing starts are up, while inventories and unfilled orders are falling. The European business cycle seems to be lagging ours; unemployment, even though as high as in the US, appears to be politically more tolerable in Western Europe because of the generosity of social insurance coverage; public sector deficits are relatively even larger than in the US; and in most European countries there is even greater aversion to adopting potentially inflationary monetary policies.

The non-OECD countries are a major drag on the OECD economies, instead of the source of stimulus they were during the 1975 recession. A dramatic decline in commodity prices, coupled with the sharp decline in international bank lending stimulated by the debt crises in Poland, Argentina, and Mexico, are forcing large cuts in both LDC and East European imports. Many of the LDCs have been forced into severe austerity. Mexico's monthly imports are running about one-half of last year's rate. Brazilian imports are falling and further substantial cuts will be necessary. Other LDCs in financial difficulties, which include most countries in Latin America and Africa, either have already or will soon have to make import cuts in order to meet foreign debt obligations despite reduced export earnings. Import growth also has ceased in OPEC countries, reflecting the softness of the oil market and the shift of most OPEC countries from surplus to deficit in their balance of payments. East European countries have cut their imports from the West by 15 to 20 percent and no near-term recovery is feasible, because of the large debt overhang, not only in Poland, but also in East Germany, Hungary, Romania, and Yugoslavia.

Although Western governments and the IMF have been providing substantial additional financing to countries in major financial difficulty, especially Mexico, Brazil, and Argentina, substantial net new bank credit will be needed to prevent a further contraction in imports during 1983. The major banks appear to be making the necessary commitments, but on condition that the recipient implement rigorous austerity programs negotiated with the IMF. These programs have not yet had much impact on most people or firms, and they have yet to be subjected to domestic political processes in the subject countries. As their impact on the employment and real incomes of various social groups become evident, political resistance to these programs is likely to grow and the chances of substantial slippage in the programs will increase. Such slippage could trigger new financial crises, force even more debt reschedulings, and further curtail new bank credit. Other factors which are likely to force further cuts in the imports of the developing countries in the absence of Western economic recovery are:

- o LDC export earnings would continue to slide even if commodity market prices level off, as longer term contracts expire.
- o Many LDCs would no longer be able to draw down foreign exchange reserves as these reserves have fallen to dangerously low levels.
- o Commercial lending to LDCs not yet facing major financial difficulties would probably slow further.

In the industrial countries, industrial production could continue to slide because of falling export demand and a continuing drop in business investment. The decline in LDC imports forced by financial troubles is already costing the US nearly one percent of GNP, and perhaps one-half of one percent in other OECD countries. Social insurance, however, is a strong stabilizer for personal incomes, and greatly diminishes the possibility of a downward economic spiral.

The global economy could be further slowed by financial instability. Large-scale LDC reschedulings are reducing bank liquidity while pressure from regulatory authorities may force banks to make longer provisions for loan losses, thereby cutting into profits. Many domestic firms, as well as foreign governments, are in serious financial trouble. And interest rate deregulation in the US will further cut into bank-profit margins. With many banks in a weakened position, a variety of shocks could trigger major liquidity crises, and threaten widespread insolvency. Some of the most worrisome, if unlikely, candidates for major shocks are:

- o Default on debt obligations in Mexico, Nigeria, and perhaps Venezuela, should the soft oil market lead to a large absolute decline in oil prices.
- o A debtors' revolt led by Brazil, with demands for a one or two year moratorium on interest payments.

Even if major financial shocks, such as these, should occur, the chances are high that prompt Central Bank action would keep all but a small number of commercial banks operating. Consequently a financial panic--taking the form of a generalized contraction of credit--will probably be avoided or, once started, quickly halted. But there is a significant possibility of financial disruptions that would boost demand for liquid assets, push up interest rates, and further curtail lending to LDCs and other weak borrowers.

A continued economic recession would have a possible silver lining--it could keep oil demand so low as to occasion the collapse of OPEC and a large decline in oil prices. Such a price decline would stimulate economic activity in the industrial West, slow inflation and ease the payments problems of many countries. But it would also create severe problems for the oil exporting countries, forcing the wealthy ones, like Saudi Arabia, to curtail foreign assistance and the use of foreign labor, and pushing the poorer ones, like Mexico, to the brink of debt default. Energy markets would be chaotic and energy investment plans severely disrupted.

On the upside, the economic upturn, when it comes, may be more rapid than generally expected. Most forecasters not only miss turning points in the business cycle, but also understate both the extent of the decline and the speed of the upturn. Once the recovery begins, the prices of some commodities may spurt because of the low level of inventories, and LDC earnings will rise.

The fallout of a continued and perhaps increasingly severe economic recession would be felt in a variety of ways. In the industrial West, pressure to reflate economies, even at the risk of rekindling rapid inflation in the longer term, will become even stronger. In the LDCs, painful austerity will generate a political struggle over economic policies; in some countries the struggle will take the form of highly nationalistic, populist reactions against foreign businessmen, bankers and the United States. The necessity of having to generate large trade surpluses by cutting imports in order to pay interest on debt may trigger a debtors' revolt, which could spread quickly. The political stability of some LDCs, notably Mexico, will be severely tested, although economic factors alone are unlikely to bring Communist or extreme left governments to power in any country.

Even if the recession does not persist much longer, protectionist measures will multiply and affect a growing part of world trade, often taking the form of de facto cartelization of major industries, such as steel and textiles. Unemployment will remain high even with economic recovery; many basic industries seem destined for long-term stagnation; a lasting or worsening recession would make things even worse. The severe erosion of US political support for free trade, threatens to remove what was the greatest barrier to cartelization. Most LDCs are most certain to respond to enforced austerity by imposing quantitative restrictions on their imports, as well as through devaluation. They are also likely to subsidize exports in one way or another and engage in as much barter trade as possible. West European countries have too much stake in intra-European trade to reimpose many barriers, but many feel little compunction about restricting imports from the outside, especially Japan and the Far Eastern NICs. US trade would be damaged by this process, both directly and indirectly.